Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

2014 - 2015

Department/Agency: ASIC
Question: AET 146-156
Topic: Regulations for CFD and FX customers
Reference: Written - 6 March 2015
Senator: Dastyari, Sam

Question:

2012 Treasury Discussion Paper "Handling and use of client money in relation to over-the-counter derivatives transactions". The paper invites further discussion:

Questions
146. Has ASIC responded to this invitation?
147. Has ASIC provided any recommendations or advice to Government on legislative reform to strengthen consumer protection for Australian CFD and retail FX investors?
148. What is holding the government back on implementing any recommendations?

I draw ASIC's attention to an article by David Rogers in The Australian newspaper on January 24 headlined "Ignorance is Bliss for those blind to Swiss Crisis" which discusses the recent upheaval in global foreign exchange markets. In January, the Swiss National Bank removed its currency peg against the Euro, leading to the Swiss franc plummeting (40% against the Euro), and the collapse and bail out of a number of retail brokers around the world. The article highlights the legislative anomaly that allows any Australian licenced CFD and retail FX providers to use client money for purposes such as hedging, providing collateral and even meeting operational expenses. While some industry leaders voluntarily segregate and protect their client funds, there is a long tail of operators who continue to use client money for other purposes.

149. Are retail investors who are with firms that do not fully segregate clients funds subject to a greater level of risk?
150. Does ASIC agree this legislative loophole presents a risk? A serious risk?
151. Could this regulatory anomaly possibly result in another MF Global situation, where retail investors suffered large scale losses?
152. What regulatory protections exist for Australian retail investors in these sectors?
153. Given that ASIC has in recent months issued warnings, cancelled licences and taken action to curb the activities of several Australian based firms offering retail FX and CFD trading services* is the agency concerned that the regulations relating to Australian domiciled companies remain comparatively lax compared to other jurisdictions?
154. Is ASIC concerned about any CFD and leveraged FX providers?
155. Has ASIC sought any information from any firms about their use of client funds after the Swiss Franc currency crisis?
156. Are the regulations governing Australian licenced CFD and retail FX providers in urgent need of strengthening and overhaul?

Answer:

146. Has ASIC responded to this invitation?

Treasury released its Discussion Paper *Handling and use of client money in relation to over-the-counter derivatives transactions* in November 2011. On 20 April 2012, ASIC made a confidential submission to Treasury's Discussion Paper.

147. Has ASIC provided any recommendations or advice to Government on legislative reform to strengthen consumer protection for Australian CFD and retail FX investors?

ASIC first wrote to Treasury in December 2008, setting out various risks to clients that arise by operation of the client money provisions in Division 2 of Part 7.8 of the Corporations Act. In this letter, we also advised Treasury that we intended to prepare a Regulatory Guide concerning the client money provisions.

In July 2010 ASIC published Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212).

On 30 August 2010, Treasury emailed to ASIC for comment a draft consultation paper that would propose legislative reforms to the client money rules. ASIC provided comments to Treasury on the draft consultation paper by letter dated 23 September 2010.

Treasury and ASIC then corresponded on the draft consultation paper in October 2010 and from April 2011 until Treasury released its Discussion Paper in November 2011. As discussed above, on 20 April 2012, ASIC made a confidential submission to Treasury's Discussion Paper.

Treasury continues to liaise with ASIC about the responses to the Discussion Paper.

148. What is holding the government back on implementing any recommendations?

ASIC is unable to answer this question. This is a question for Treasury and government.

149. Are retail investors who are with firms that do not fully segregate clients funds subject to a greater level of risk?

It will depend on the circumstances and how the client money is used, however, there can be an increased exposure to counterparty risk, particularly associated with the failure of another client where the money for both clients is not segregated or the failure of the licensee.

In RG 212 at RG 212.14 we outline the counterparty risks clients can be exposed to with respect to client money:

Even though the client money account is a separate account subject to a statutory trust, clients are exposed to counterparty risk with respect to client money. That is, the risk that in the event of the failure of another client or the licensee, a client will not receive all of their client money back. This arises because:

(a) the licensee is permitted to use client money to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee, including dealings on behalf of people other than the client;

(b) the licensee may make a withdrawal from a client money account of money to which it is entitled and that entitlement may be created under the terms of its client agreement by specifying when margin is due and payable; and

(c) the licensee may make a payment out of client money if it has obtained a written direction from the person entitled to the money—we understand that the client agreements of AFS licensees dealing in derivatives may contain a broad authorisation from clients for the licensees to make withdrawals from client money for any purpose whatsoever.

Further explanation the counterparty risks to client money is given in Section D of RG 212: http://download.asic.gov.au/media/1241354/rg212-9july2010.pdf

In the case of MF Global which held money on behalf of Australian clients and those moneys were held in segregated accounts, for example, the risk to clients was magnified by the complexity of that company's operations. MF Global Australia's business model involved paying Australian client money and margins to other MF Global entities overseas, and also using services, such as futures clearing services, provided by overseas MF Global entities. Once the overseas entity experienced financial trouble, these amounts became subject to complex insolvency proceedings across several jurisdictions.

150. Does ASIC agree this legislative loophole presents a risk? A serious risk?

As mentioned above, ASIC determined a need to release RG 212 to clarify the uses of client money under Australian requirements. In addition, we have published Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors*, which contains a series of benchmark disclosures that we consider are critical for investors to know. These include, among other things, benchmarks regarding:

- counterparty risk—hedging (see RG 227.51–RG 227.58); and
- client money (see RG 227.67–RG 227.75).

ASIC has also published investor education material discussing the risks associated with trading in CFDs and FX, including details of the risks associated with the use of client money

risk *https://www.moneysmart.gov.au/tools-and-resources/publications/thinking-of-trading-cfds*. ASIC considers that the measures it has described above are the extent to which ASIC can address the risks associated with the handling of client moneys within the scope of the current legislation and ASIC's powers. The UK has passed measures that prevent retail OTC derivatives issuers in the UK from using client money held for retail clients in the manner currently permitted in Australia by section 981D of the Act.

151. Could this regulatory anomaly possibly result in another MF Global situation, where retail investors suffered large scale losses?

ASIC notes the regulatory requirements have not changed since the MF Global event and therefore a similar event could occur.

153. Given that ASIC has in recent months issued warnings, cancelled licences and taken action to curb the activities of several Australian based firms offering retail FX and CFD trading services* is the agency concerned that the regulations relating to Australian domiciled companies remain comparatively lax compared to other jurisdictions?

ASIC has publicly stated it has a current focus on retail over-the-counter (OTC) derivative providers, including margin foreign exchange.

Over the past two years, ASIC has seen an increase in the number of entities applying for an AFS licence authorising the entity to operate a retail OTC derivative business, particularly in the area of retail margin foreign exchange services and we are concerned about the level of non-compliance with current regulatory requirements by entities in that industry.

Consideration of law reform issues is a matter for Treasury and Government. ASIC notes other jurisdictions do have requirements that are stricter than Australian requirements on the following matters:

- allowed uses of client money;
- capital requirements; and
- caps on leverage.

154. Is ASIC concerned about any CFD and leveraged FX providers?

ASIC is unable to comment on ongoing operational matters but has publicly stated it has a current focus on retail over-the-counter (OTC) derivative providers, including margin foreign exchange.

155. Has ASIC sought any information from any firms about their use of client funds after the Swiss Franc currency crisis?

The day after the Swiss Franc currency crisis, ASIC contacted all relevant Australian retail derivative stakeholders and reminded them of their obligations:

- to notify ASIC of any event occurs that may make a material adverse change to the financial position compared to its financial position stated in any documents lodged with ASIC.
- to report net tangible asset (NTA) positions where they fall below 110% of the required NTA;
- to cease transactions where they have reasonable belief that they will not comply with s912A of the Act and where there is or will be a deficiency in any accounts maintained by the licensee for the purposes of s981B;
- to cease transactions where the NTA falls below 75% of required NTA; and
- to ensure they do not incur any further debts if there are reasonable grounds for suspecting that a company is insolvent (or may become insolvent).

ASIC is unable to comment on operational matters on any additional enquiries made by it of individual stakeholders.

156. Are the regulations governing Australian licenced CFD and retail FX providers in urgent need of strengthening and overhaul?

Consideration of law reform issues is a matter for Treasury and Government. Other jurisdictions, particularly the UK have reformed their client money handling requirements following the outcomes of the MF Global failure.